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Banking Reform in China: Constructing an Economic Lever [redacted]

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A Research Paper

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February 1986

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Banking Reform in China: Constructing an Economic Lever [redacted] 25X1

A Research Paper

This paper was prepared by [redacted] Office of East Asian Analysis. Comments and queries are welcome and may be directed to the Chief, China Division, OEA, [redacted] 25X1 25X1

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Banking Reform in China: Constructing an Economic Lever [redacted]

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Summary

Information available as of 21 January 1986 was used in this report.

Chinese reformers are counting on a revitalized banking system to play a critical role in controlling economic activity as Beijing implements its ambitious economic reform program. For more than 30 years under China's centrally planned economic system, banks were little more than cashiers and accountants for the Ministry of Finance, and bank managers often were appointed on the basis of political orthodoxy rather than economic acumen. Efforts to improve efficiency throughout the economy by reducing the scope of mandatory planning and employing material incentives, however, forced Beijing to reconsider the role of banks in the economy. [redacted] 25X1

In the complex political struggle that surrounds economic reform in China, restructuring the banking system is an important testing ground for the reformers. When reforms were launched in 1979, conservatives warned that Beijing could lose control of the economy if the central planning mechanism was weakened—and argued that strict limits should therefore be placed on economic decentralization. Reformers countered that indirect economic levers—such as credit levels or interest rates—could be used to regulate economic activity occurring outside the plan. [redacted] 25X1

China's banking system, however, was woefully unprepared to provide those economic levers. The central bank lacked tools for conducting monetary policy and was hampered by having to conduct both commercial and oversight activities. Senior bank officials often had only a dim view of modern banking practices, and lower level bank managers—used to being told to whom to loan money—had almost no experience conducting project evaluations or basing lending decisions on economic criteria. [redacted] 25X1

In the past seven years, and particularly since 1982, Beijing has made a major overhaul of its financial system to enable banks to meet the monetary demands accompanying economic reforms. Beijing has expanded the authority of, and increased the monetary tools available to, its central bank so that it can flexibly adjust credit levels to maintain macroeconomic stability while the old regulatory mechanism of central planning and administrative directives is partially dismantled. To improve the allocation of funds, local banks simultaneously have been given greater autonomy over lending decisions, and bank loans increasingly are replacing government budget grants for enterprise investment. [redacted] 25X1

EA 86-10007
February 1986

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By reducing the scope of central planning and delegating decisionmaking authority to lower levels, Beijing has increased the responsiveness of China's economy to monetary policy. Beijing intends to conduct a more active monetary policy to maintain macroeconomic stability, but poorly formulated or inappropriately executed monetary policy now will have a much more deleterious impact on the economy than before the reforms. 25X1

The danger of proceeding with industrial reforms before the banking system is capable of regulating the economy was illustrated during the past two years. Beijing's reform program suffered a major setback in 1984, when currency in circulation and loans to industrial enterprises increased 50 percent. This contributed to runaway industrial growth, a jump in inflation, and a sharp drop in China's foreign exchange reserves. The credit surge was sparked by increased enterprise autonomy and central instructions to banks to provide loans to promote reform. Lax oversight and muddled accounting by the central bank allowed credit to increase much more than Beijing intended. A tight monetary policy implemented in the spring of 1985 has gradually slowed the economy, but continuing investigations of credit practices within the banking system suggests that Beijing has not recovered from the credit binge. 25X1

Despite the painful adjustments of the 1984-85 period, we believe China has been benefiting from bank reform. The increased use of loans in place of budget grants, for instance, has sped the turnover of working capital and reduced construction periods, and greater flexibility by rural banks to issue loans has boosted the development of specialized farming and rural industries. Bank willingness to loan more to family and small-scale enterprises clearly has stimulated important growth in the private and collective sectors of the economy—goals long sought by economic reformers. Benefits of bank reform have been limited, however, by a shortage of skilled bank managers and by continued interference in lending decisions by local government and party officials. We believe, moreover, that monetary control techniques are not yet reliable, and Beijing faces substantial risks that monetary policy may actually be destabilizing—as it was in 1984. 25X1

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At the party conference in September 1985, Beijing reiterated its determination to complete the transformation of the banking system during the next five years. We believe Beijing will increase the use of interest rates as economic levers, promote greater competition among banks, broaden the range of financial instruments available, and establish a short-term capital market. Even when the reforms are implemented fully, however, the state will continue to dominate the banking sector. Thus, the banking system will retain many of the characteristics of a monopoly bank and will provide Beijing with a powerful economic control mechanism. 25X1

Bank reform probably will facilitate increased US trade with China. Chinese banks may become more willing to lend for imports or joint ventures as Beijing grants them greater flexibility in handling foreign exchange. Proceeds from the sale of foreign-currency-denominated bonds—recently issued for public purchase outside China for the first time since 1949—may go toward Chinese imports of US industrial equipment and high-technology products. Beijing's decision to allow foreign banks to establish wholly owned or joint-venture branches in China's four Special Economic Zones will increase opportunities for US banks to set up offices in China. 25X1

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Contents

25X1

Banking Reform in China: Constructing an Economic Lever

25X1

The Need for Banking Reform

As Premier Zhao Ziyang stated in a recent interview, one of the key problems Beijing's reform program faces is how to maintain macroeconomic stability while reducing direct government control over state enterprises. Before industrial reforms were implemented, overall economic control was maintained through mandatory plans and administrative directives. Central planners established output targets for key products, and the wages of staff and workers—and most prices—were fixed by the state. Central and provincial governments determined the scale of investment spending, while the Ministry of Foreign Trade monopolized imports and exports and strictly controlled external capital flows. Given these pervasive economic controls, unplanned changes in aggregate demand could arise only from fluctuations in consumer spending.[1] An unexpected increase in consumer spending, moreover, had little effect on prices or employment; its main impact was to increase shortages of retail goods.

Reforms implemented since 1978 have sharply diminished administrative control over economic activity. In hopes of improving industrial performance, Beijing has reduced the scope of mandatory planning while giving enterprise managers greater decisionmaking authority. Enterprises now retain a much larger share of earnings—which they can use for investment, or wages and bonuses—and are permitted to sell overquota production of industrial goods at prices above state-set levels. Price and wage controls have been relaxed, and more retail goods are marketed outside government-run commercial channels.

Central planning still plays an important role in China's economy. By allowing enterprises increased autonomy over production decisions, however, Beijing has given up an element of direct control over aggregate demand. As enterprise managers determine investment spending and wage payments on their own, rather than following guidelines set by central planners, much sharper fluctuations in aggregate demand may occur. 25X1

Reformers hope to control aggregate demand—and maintain economic stability—through indirect economic levers employed by a revitalized banking system.[2] Monetary authorities in particular have been assigned responsibility for adjusting interest rates and credit levels to offset undesirable changes in investment or consumer spending. 25X1

Beijing also intends to have the banking system play an increasingly large role in funding investment projects. Reformers recognize that interest-free budget grants in the past encouraged wasteful use of investment funds and extended construction periods. Beijing hopes that interest rates will serve as a lever to speed up the turnover of funds, and that banks will investigate projects more closely for their potential profitability. 25X1 25X1

The System Reformers Inherited

When China's economic reform program was launched in 1979, the banking system was woefully unprepared to undertake an active monetary role. Bank managers, used to following administrative directives, had little knowlege of modern banking techniques. Moreover, China's central bank lacked the tools for controlling credit used by Western central banks (such as open market sales of government 25X1

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[1] Aggregate demand refers to the total demand for goods and services produced in an economy, and is made up of consumer demand, desired investment spending, government expenditures, and net exports (exports minus desired imports).

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securities and changes in the central bank discount rate), and was hampered by having to conduct both commercial and regulatory activities. The primary problem reformers faced was that for more than three decades Chinese banks had not been allowed to operate like banks. [redacted]

Within the confines of China's centrally planned economy, the banking system was charged with facilitating attainment of the national economic plan, but, because most credit was provided from government budget grants, banks often served as little more than cashiers and accountants for the Ministry of Finance. Monetary policy was "passive" in that credit levels were not purposefully adjusted to counter changes in aggregate demand, and the banking system played little role in maintaining financial stability. The banking system's close monitoring of currency and credit flows, however, provided economic planners with important financial data. [redacted]

The Ministry of Finance used government revenues to supply investment funds and enough working capital to enterprises to meet planned production targets. Interest was not charged on these budget grants, and principal was not expected to be repaid, because the allocation of funds was determined by the central plan and because enterprises were required to turn over all profits to the state anyway. Banks did not offer loans for investment, but supplied short-term financing to meet enterprises' unplanned needs for funds. Banks charged interest on working capital loans primarily so they could cover interest payments on household savings accounts. [redacted]

Banks were supposed to keep the growth of household currency holdings in line with available supplies of consumer goods, but most of the factors affecting household currency holdings were outside the control of banking authorities. Credit entered circulation mainly through wage payments to urban workers and through state purchases of agricultural products. Currency was withdrawn when consumers purchased goods from state and cooperative firms. The banks' role in adjusting currency supplies was to encourage additions to, or withdrawals from, household savings deposits. Interest rates were set by the state and rarely changed, however, so moral suasion was the main tool that banks had to induce changes in savings deposits. [redacted] 25X1

Banks used the ratio of retail sales to currency in circulation as a key currency indicator. If the ratio fell below a target level—indicating excessive amounts of currency in circulation—banks did not have the power to stop payment of excess wages or withhold credit used to procure agricultural products. Instead, they could only alert the appropriate government supervisory authorities. [redacted] 25X1
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The banking sector used administrative controls to keep financial developments in the enterprise sector separate from developments in the household sector. Enterprises and government units were required to settle accounts with each other by bank transfers that were closely scrutinized to ensure compliance with the economic plan. Enterprises could hold currency only under very restrictive conditions, and were not allowed to extend credit to other enterprises. To prevent banks from competing for business, enterprises were assigned to particular banks. Individuals received cash for wages and sales of agricultural products, but

Suppliers of Credit Under Political Duress

During the Great Leap Forward (1958-60) and the Cultural Revolution (1966-76), banking policies and operations were subject to political criteria to an unprecedented extent. During the Great Leap Forward, boosting output rapidly became a means for factory managers and local officials to show adherence to the party line. Banks were instructed to grant loans whenever enterprises requested funds to meet production targets, and it became almost impossible for banks to refuse any loan request. During the Cultural Revolution, China's central bank was subsumed under the Ministry of Finance, and its local branches were taken over by party committees that used them as personal suppliers of funds for the expansion of enterprise output. [redacted] 25X1
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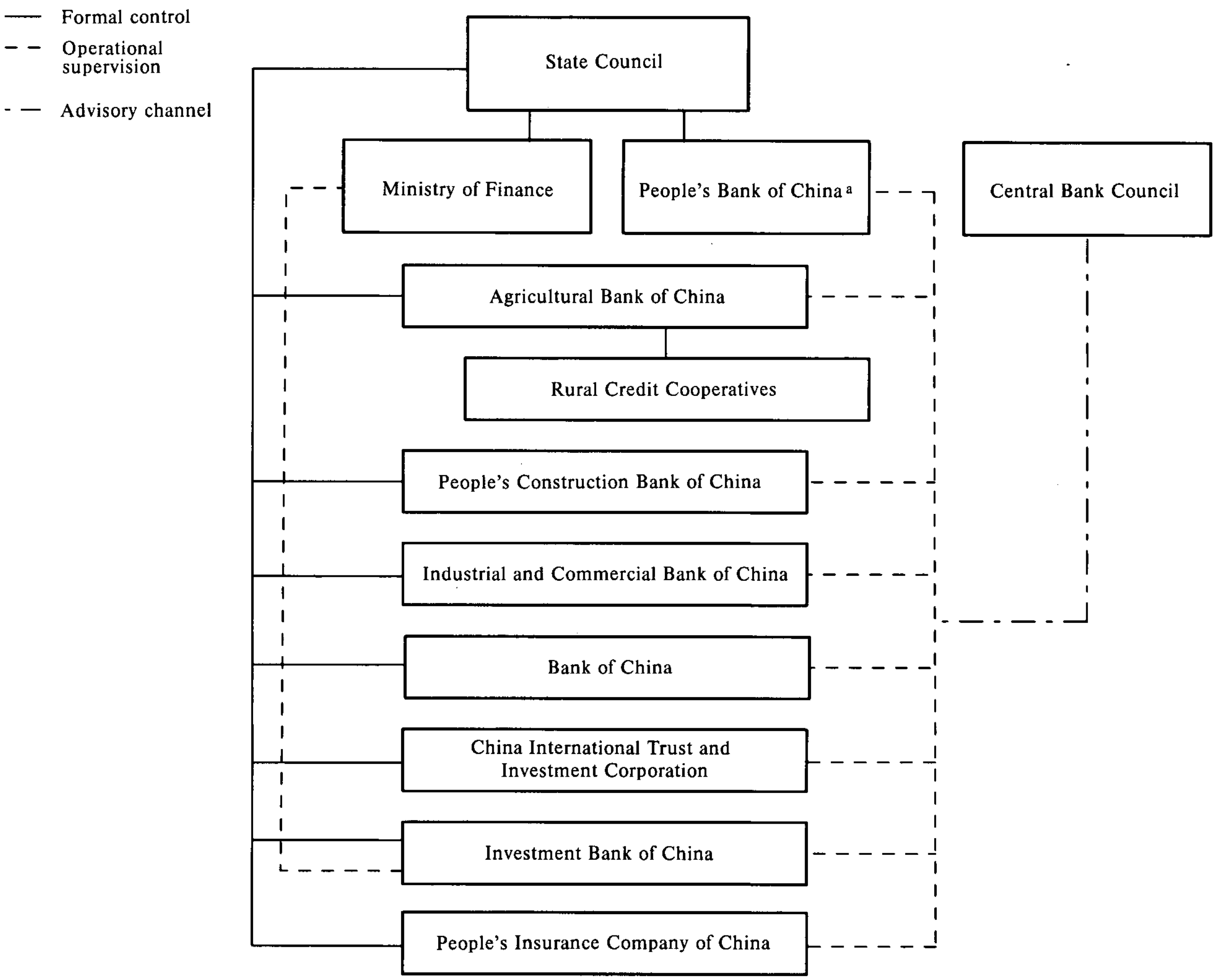
Figure 1
China's Banking Structure Today



[a] The specialized banks, CITIC, and PICC are directly subordinate to the State Council, but Beijing has delegated supervision of their banking activities to the People's Bank. The specialized banks, however, handle matters such as wage payments, personnel decisions, and internal operations independently of the PBOC. The People's Bank initially was limited to recommending policies for the specialized banks, but its control over banking activities has been strengthened since 1983.

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Chinese Financial Institutions

*For 35 years the **People's Bank of China (PBOC)** was China's central bank and also its largest commercial bank. Since 1983, when its commercial banking operations were split off, the People's Bank increasingly has functioned as a true central bank. The PBOC has the status of a ministry directly under the State Council and is charged with formulating monetary policy and developing credit and currency targets that are consistent with annual economic plans and long-run development goals. The central bank controls the issue of currency, sets interest rates, and approves the establishment, closure, or merger of financial organizations. The central bank is responsible for auditing financial institutions, and, since August 1985, has managed the State Treasury—overseeing the collection and distribution of government revenues. The PBOC also sets China's exchange rate, controls state holdings of foreign exchange, regulates the issuance of foreign-currency-denominated bonds, and represents the government in interactions with international monetary organizations.*

*The **Agricultural Bank of China (ABC)** was created in 1955, then abolished in 1957 when its duties were taken over by the PBOC. It was reestablished in February 1979 to handle banking operations in rural areas. The ABC specializes in collecting saving deposits from peasants and offering loans in support of agricultural production and rural industry. It is the main channel for state loans and investment to agriculture, and is responsible for collecting revenue in the countryside. The ABC also oversees the operations of the rural credit cooperatives.*

*The **rural credit cooperatives (RCCs)** were created in the countryside during the period of rural collectivization in the 1950s. Although collectively owned, they operate essentially as grassroots units of the Agricultural Bank. Their resources come mostly from farmers' deposits and borrowings from the Agricultural Bank, and their funds are invested mainly in the rural economy. The RCCs recently have been given an expanded role in extending credit in the countryside.* 25X1

*The **People's Construction Bank of China (PCBC)** was established in 1954 to manage the state's capital construction funds. Prior to 1979, its primary function was to distribute state budget allocations to enterprises for investment projects, and to oversee the operations of state construction units. Until 1979, the Construction Bank was subordinate to the Ministry of Finance and the State Capital Construction Commission, and operated more like a fiscal agent of the Ministry than as a bank. The role of the Construction Bank has changed significantly during the past few years. In August 1979, the PCBC issued repayable, interest-bearing bank loans for construction projects on a trial basis.* 25X1 *The experiment was broadened when the State Council decided in November 1980 that all capital construction appropriations to enterprises that had been granted independent accounting authority would assume the form of bank loans. The Construction Bank now distributes both appropriations and loans for capital construction. It also extends loans for the production of industrial commodities for export, and takes deposits from construction organizations and geological prospecting units.* 25X1

*The **Industrial and Commercial Bank of China (ICBC)** was created in January 1984 to take over the commercial operations of the People's Bank of China. The Industrial and Commercial Bank accepts savings deposits from urban residents, enterprises, and* 25X1 *government organizations, and offers working capital loans to state-run and urban collective enterprises as well as to individuals engaged in industry and commerce. The ICBC also settles accounts between firms, and monitors financial accounts—particularly wage funds—of state-run enterprises.*

Since 1949 the ***Bank of China (BOC)*** *has specialized in the management of foreign exchange and the settlement of China's international trade and service accounts. The BOC handles foreign currency loans and deposits in China, including remittances from overseas Chinese. Besides carrying out investment overseas, the BOC offers Chinese and foreign currency loans to Chinese enterprises and domestic joint ventures. The Bank of China maintains correspondent relationships with about 1,200 foreign banks in 150 countries, and has opened more than 280 overseas branches (including two in the United States). The BOC is also authorized to sell foreign-currency-denominated bonds for the central government. Because of recent bank reforms, the BOC no longer monopolizes China's international financial dealings.*

China International Trust and Investment Corporation (CITIC) *was established in October 1979 to serve as an intermediary in arranging joint ventures between Chinese and foreign firms. The goal of the corporation is to introduce foreign funds and technology and promote investment in China. Since January 1982, Beijing has allowed CITIC to raise capital by selling foreign-currency-denominated bonds. Besides lending funds to domestic joint ventures, CITIC also has made equity investments in joint ventures.*

The ***China Investment Bank (CIB)*** *was created in December 1981 with World Bank funds to provide loans for small-scale industrial modernization projects. Unlike CITIC, which seeks investment funds primarily from private sources, the Investment Bank's main business consists of arranging long- and medium-term loans from international monetary or-* 25X1 *ganizations—primarily the World Bank. The CIB also engages in capital participation with joint ventures and organizes syndicate loans. The China Investment Bank works closely with the Ministry of Finance and the Construction Bank.* 25X1

After being virtually suspended in 1958, the insurance business was revived when the ***People's Insurance Company of China (PICC)*** *was reinstated in 1980 to provide property and transportation insurance for households and enterprises. In January 1984 the People's Insurance Company was split off from the People's Bank of China. The PICC handles both domestic and overseas insurance and recently has developed life, health, auto, and agricultural insurance.* 25X1

Beijing created the ***Central Bank Council*** *in January* 25X1 *1984 to serve as the key advisory body within the banking system. The council is headed by the president of the People's Bank and is composed of vice presidents and financial advisors of the PBOC, presidents of the specialized banks, and one vice-minister each from the Ministry of Finance, the State Planning Commission, and the State Economic Commission. The Central Bank Council gives advice on monetary policy, analyzes the adequacy of credit policies in relation to the economic plan, and examines institutional developments within the banking* 25X1 *system.* 25X1 could use their currency only to purchase consumer goods or increase their savings deposits. Banks did not offer loans to individuals.

Changing the Structure of the Banking System

Recognizing that banking reform must accompany other economic reforms, Beijing has been making major institutional changes in its banking system during the past seven years. Beijing has reestablished a network of rural banks, stopped using its construction banks solely as conduits for Ministry of Finance funds, spun off the commercial banking operations formerly conducted by its central bank, and ended the monopoly on international financial transactions held by its foreign exchange banks. After key reforms in 1983 and 1984, China's banking system now consists of a central bank and a number of banks that specialize in particular types of financial operations.

The centerpiece of Beijing's bank reform strategy is to strengthen the powers of the People's Bank of China (PBOC) to enable it to function as a true central bank. After being subsumed under the Ministry of Finance during the Cultural Revolution, the PBOC was reinstated as a direct adjunct of the State Council by a decision of the National People's Congress in 1978. The People's Bank, however, continued to be hampered in its oversight role by having to conduct daily commercial operations—including monitoring financial activities of state enterprises. A series of banking reforms announced by the State Council in September 1983 significantly enhanced the powers of the PBOC as a central bank:

- The PBOC was designated as China's sole central bank, its right to manage the specialized banks and other financial institutions was expanded, and the status of the specialized banks, China International Trust and Investment Corporation (CITIC), and People's Insurance Company of China (PICC) was downgraded correspondingly.
- The PBOC's deposit and lending divisions were separated from its central banking divisions (and transferred to the ICBC when it was formally established on 1 January 1984.)
- The PBOC's guidance over loans offered by the Construction Bank was strengthened.
- The State Administration of Exchange Control was transferred from the Bank of China to the PBOC.[3]
- The State Council announced the formation of the Central Bank Council.

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Although the banking reforms in September 1983 strengthened the power of the PBOC over the specialized banks, the Ministry of Finance continued to exert a strong influence over the banking system through its authority to establish economic policy guidelines and to interpret regulations. We believe, however, that the Ministry's influence was eroded in 1985. A State Council decision late in July 1985, for instance, gave the PBOC control of the State Treasury—an economic department we believe was run formerly by the Ministry of Finance. In our view, the Ministry probably now exercises very little direct administrative control over the banking system.

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The PBOC supervises the banking system through its network of branch banks. The People's Bank has branches in China's provinces—which are subordinate to the head office in Beijing—and secondary branches in prefectures, large cities, and some counties—which are subordinate to the provincial offices. Branch banks regulate credit and currency flows in their localities and supervise the operations of the specialized banks and other financial institutions within their jurisdictions. Beijing's goal is for the PBOC increasingly to use economic levers—such as changes in the central bank lending rate—rather than administrative edicts, to guide the credit practices of the specialized banks.

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[3] The State Administration of Exchange Control, established in March 1979, is a specialized financial organ that formulates regulations governing the use of foreign exchange, supervises all foreign exchange receipts and disbursements, and periodically announces new exchange rates.

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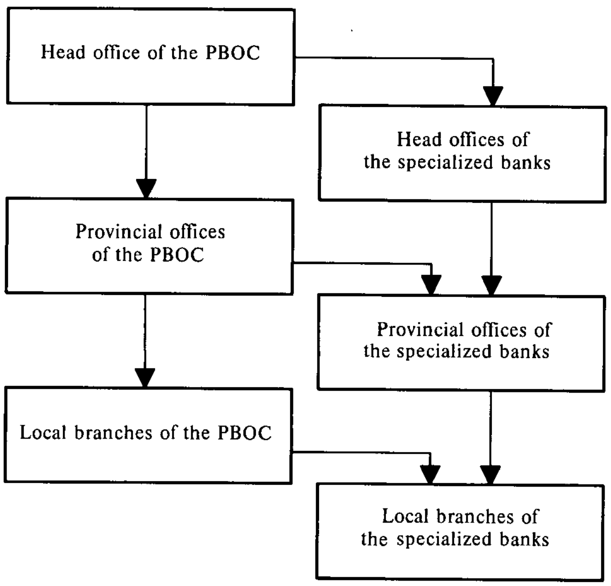
Figure 2
Lines of Supervision in China's Banking System



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How the PBOC Conducts Monetary Policy

The main focus of monetary policy in China remains the development of credit and currency targets that complement the economic plan, but Beijing increasingly is calling on the People's Bank to play a more active role managing macroeconomic activity. Central banks in market economies use open market operations, discount rate adjustments, and changes in reserve requirements to regulate the volume of credit.[4]

[4] Open market operations refer to central bank sales (or purchases) of government securities to (or from) commercial banks and the public. Discount rate changes are changes in the interest rate paid by commercial banks when borrowing from the central bank. Reserve requirement changes refer to changes in the amount of reserves a commercial bank must maintain in relation to its total deposits. Open market sales of securities, increases in the discount rate, or increases in reserve requirements tend to decrease the amount of reserves available to the banking system, and thus, the total volume of credit in the economy. 25X1

The primary monetary tools used by the People's Bank are quantitative restrictions on the amount of loans that the specialized banks can offer. Beijing is moving quickly, however, to expand the number of monetary control instruments available to the PBOC, including reserve requirement and discount rate changes. 25X1

The head office of the People's Bank approves credit plans for each of the specialized banks—including target levels for loans, deposits, and borrowing from the PBOC. The specialized banks then assign credit ceilings to their provincial branches. On the basis of the provincial ceilings established by the specialized banks, the PBOC head office instructs its branches on how much they can lend to the specialized banks in each province. The People's Bank may set additional restrictions on particular types of loans and, in the wake of excessive credit expansion in 1984, the PBOC now maintains quarterly credit limits for the specialized banks. There are no formal penalties, however, for exceeding credit limits, and the PBOC has had problems keeping specialized banks from exceeding their ceilings. 25X1

China instituted a reserve requirement system in 1984, whereby financial institutions were required to turn over a stipulated percentage of their deposits to the PBOC. Originally, the reserve percentage was 25X1
based on the type of deposits, but in 1985 a uniform reserve ratio of 10 percent was set for all banks. 25X1

The People's Bank increased its discount rate in 1985 to tighten control over specialized bank borrowing from the PBOC. In 1984, the PBOC charged the same interest rate on loans to the specialized banks as it paid the specialized banks for their reserve deposits—thereby greatly limiting the effectiveness of having a reserve requirement. In 1985 the PBOC increased its discount rate to 4.68 percent annually, while holding the rate on specialized bank deposits with the PBOC to 4.32 percent. If a specialized bank needed funds in excess of its limit in the credit plan, it could borrow short-term funds from the PBOC at a 5.04-percent annual rate. We expect that in the next

China:
Annual Interest Rates on Deposits and Loans

	After 1980 Increase	After 1982 Increase	After 1984 Increase	After April 1985 Increase	After August 1985 Increase
Deposits					
Individual					
On sight	2.88	2.88	2.88	2.88	2.88
Six months	4.32	4.32	4.32	5.40	6.12
One year	5.40	5.76	5.76	6.84	7.2
Three years	6.12	6.84	6.84	7.92	8.28
Five years	6.84	7.20	7.20	8.28	9.36
Institutional					
On sight	1.8	1.8	1.8	1.8	1.8
One year	a	3.6	3.6	4.32	4.32
Two years	a	4.32	4.32	5.04	5.04
Three years	a	5.04	5.04	5.76	5.76
Loans					
Industrial and commercial					
Working capital	5.04	7.2	7.2	7.92	7.92
Short and medium term fixed asset					
One year or less	5.04	5.04	5.04	5.04	7.92
One to three years	5.04	5.76	5.76	5.76	8.64
Three to five years	5.04	6.48	6.48	6.48	9.36
Five to ten years	NA	NA	NA	7.20	10.08
Individually owned enterprises	a	NA	8.64	9.36-11.52	9.36-11.52
AG bank loans					
Working capital loans	4.30	5.76	7.2	7.92	7.92
Equipment loans	4.32-5.04	4.32-5.04	7.2	NA	NA

[a] indicates that the financial instrument was not used.

[redacted] 25X1

year Beijing will widen the difference between the discount rate and the rate paid on reserve deposits of the specialized banks. [redacted]

China also is making greater use of interest rates on commercial loans and savings accounts as levers to enhance macroeconomic stability. After keeping interest rates almost unchanged during 1965-78, Beijing raised the general structure of interest rates five times in the past seven years. Beijing hopes that higher rates on savings deposits will encourage increased consumer saving—reducing the demand pressure caused by rapid increases in personal income and providing funds for priority investment projects. Higher rates on loans are to discourage wasteful or unproductive enterprise investment. We judge it probable that Beijing will raise interest rates again in 1986 (see table). [redacted]

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The People's Bank continues to use administrative controls to supplement credit quotas and indirect monetary levers. For instance, when central officials became alarmed that wage payments were growing too rapidly in 1985, they reinstated the requirement that enterprises conduct all wage disbursements through separate bank accounts. The Industrial and Commercial Bank is to monitor enterprise accounts, and alert the appropriate government authorities if enterprises divert bank deposits designated for tax payments, investment, or retirement funds into wage payments.

Because China lacks a secondary market for government securities, the People's Bank cannot employ the primary monetary control tool used by central banks in market economies—open market operations—and we do not believe this will be possible for some time. Direct sales of treasury bonds by the government, however, do provide an important means of absorbing excess funds. After being suspended in 1958, Beijing resumed issuing treasury bonds in 1981. Initially, sales were restricted to state-owned and collective enterprises and government organizations, but sales to individuals began in 1982 and have accounted for about half of the 4 billion yuan sold each year since then. Beijing planned to sell 6 billion yuan of bonds in 1985, with the increase in sales aimed at individual buyers.[5] Reselling government bonds is prohibited, but in 1985 for the first time, bonds can be discounted at banks to allow individuals to recover their funds if they need cash before the bonds mature, and the bonds can be used as collateral for bank borrowing.

Microeconomic Reforms To Improve the Allocation of Funds

China's specialized banks are gradually being transformed into independent enterprises—responsible for their own profits and losses—that operate under broad PBOC supervision. Local branches of the specialized banks have been given greater flexibility in allocating their overall credit targets between different types of loans, and have the right to restrict credit to inefficient enterprises or deny loans that would go toward financing excessive stocks of goods. The PBOC encourages local banks to conduct feasibility studies before issuing loans, and to check periodically on how loans are being used by the borrowers. Banks now can lengthen or shorten the terms of loans, and some banks may adjust loan rates within a 20-percent range of the rates set by the PBOC. If branches are able to attract more savings deposits, they have the right to extend more loans rather than remit the extra funds to their head office, but branches still must meet a target established by their head office for the net amount of deposits and loans outstanding at the end of the year. 25X1

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Beijing has given banks much more flexibility to meet the needs of customers. In 1982 enterprises and organizations for the first time were allowed to hold time deposits (which earn much higher rates of return than the sight deposits they were required to hold previously). Banks also have introduced new types of loans, such as housing loans. Some banks have improved the convenience of their services by organizing mobile bank teams that go door-to-door to collect savings deposits. 25X1

To improve the allocation of funds between regions, Beijing has granted permission for branches of a specialized bank to transfer funds among themselves, and for a specialized bank to borrow from other specialized banks. 25X1

25X1 beginning in 1985 provincial offices of the PBOC have been encouraged to organize a market for interbank funds. Apparently, a specialized bank's excess deposits and unutilized credit may be released to other specialized banks for a maximum of 10 days. The interest rate charged for these short-term funds is to be linked to the PBOC discount rate. 25X1 Although in its infancy, we believe that regional differences in rates of return on capital will spur rapid development of this interbank funds market—if Beijing permits.[6] 25X1

[5] In 1985, the bonds offered a 9-percent interest rate for individuals and a 5-percent interest rate for institution buyers (which are comparable to yields on bank savings accounts). The bonds had a five-year maturity with interest and principal to be paid at maturity. The PBOC handles the issuance of treasury bonds and the payment of principal and interest, and receives a fee from the Ministry of Finance for acting as its agent. 25X1

[6] Xue Muqiao, an eminent reform economist, has stated that banks in northwest China tend to have surplus funds, while banks in the southeast are short of funds. Allowing interregional borrowing apparently has caused a flow of funds from the northwest to the southeast. 25X1

Bank loans increasingly are supplanting budget grants in financing both working capital of enterprises and investment spending.[7] For instance, a middle-level official with the State Economic Commission reported to Embassy Beijing that, in the next five years, almost all funds for technical transformation of state enterprises will be in the form of bank loans. Beijing hopes that allocation of investment funds will be improved when profit-seeking banks carefully screen prospective borrowers and when enterprises are forced to bear the costs of financial capital.

Financial Experiments

To absorb surplus funds that are outside the banking system, and to prod banks to improve their operations, Beijing in the past year has begun to experiment with new financial forms and instruments such as private credit institutions, enterprise shares, and bank "bonds." Beijing also is allowing foreign banks to increase operations in China, albeit on a limited scale. Practical and ideological problems, however, have caused some wavering of leadership attitudes toward these experiments.

Popular Credit Institutions

In what perhaps is a concession to an already flourishing practice, Beijing is encouraging peasants to pool their earnings and form private credit institutions to support the development of rural industry and agricultural production. These "popular" credit institutions—often taking the form of local credit unions or joint-stock operations—were praised by Vice Premier Wan Li in a speech at a national rural work conference in December 1984 as important supplements to the Agricultural Bank and the rural credit cooperatives. Provincial officials, too, have urged peasants to rely on their own efforts in raising funds for investment. According to provincial media, popular credit institutions often outbid rural banks and credit cooperatives for funds by offering higher rates of return, and extend loans at above-bank rates to peasants and enterprises that have no other source of credit. 25X1

We believe that Beijing's willingness to loosen control of rural credit by sanctioning the development of private credit institutions reflects disappointment with the pace of reform in the rural banking system. In his speech, Wan referred to unresolved structural problems that limit rural banks and credit cooperatives. 25X1
Chinese press reports in January 1986, however, suggest that policymakers are concerned with the high interest rates often charged on loans by these institutions. 25X1

Domestic Trust and Investment Corporations

With PBOC approval, branches of the specialized banks, and some provinces and cities, have set up trust and investment corporations to channel surplus financial resources of enterprises and local governments into new investment activities. The corporations handle trust loans, trust investments, trust leasing, and provide consulting services. Provincial media suggest, however, that Beijing temporarily called a halt to 25X1
trust loans in some provinces in August 1985—apparently because of concerns about excessively rapid and unregulated growth of these loans. 25X1

Enterprise Shares

According to a banking journal published by the PBOC, 58 cities that are designated as "laboratories for reform" have allowed some state enterprises to issue bonds to their own staff and workers. Chinese media suggest that local authorities also are issuing bonds or shares to raise funds for local capital investment. 25X1

Bank Bonds

In August 1985 Beijing announced that the Agricultural Bank would be allowed to sell 1.5 billion yuan of bonds in the countryside to raise funds for rural enterprises producing goods for export or firms undertaking investment projects that banks deem profitable. The bonds have a one-year term and pay

[7] Funds for investment spending come from budget allocations, bank loans, self-raised funds, and retained earnings of enterprises. Most budget allocations for capital construction now are made as interest-bearing loans instead of grants. When loans are extended on the basis of budget allocations, the Ministry of Finance has claim on repayment of principal, but banks retain interest payments. When banks use their own funds to extend loans, the banks have claim on both principal and interest.

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9-percent interest on maturity, and funds are to be loaned out at interest rates of 12 to 14 percent. Beijing also authorized the Industrial and Commercial Bank to issue 500 million yuan of bonds bearing the same rate and maturity to urban residents. Proceeds of the ICBC bond sale are to be loaned to urban collective enterprises producing consumer goods that are in short supply.

Because bank bonds cannot be traded or discounted, they actually are more akin to certificates of deposits than bonds, in the Western use of the terms. An Agricultural Bank official told Embassy Beijing that this type of financing could become an increasingly important source of funds. Because the bank bonds carry higher interest rates than bank deposits of comparable maturity, we expect these financial instruments to be very popular with Chinese households.

Branches of Foreign Banks [8]

In April 1985 Beijing promulgated an ordinance allowing foreign banks to establish wholly owned or joint-venture branches in the four Special Economic Zones (Shenzhen, Zhuhai, Shantou, and Xiamen). Upon approval of the PBOC, branches of foreign banks will be allowed to settle foreign trade transactions and handle foreign currency deposits and loans and remit foreign exchange earnings for joint ventures. Foreign banks, however, must follow strict state guidelines in setting interest rates on loans and deposits, and can offer foreign currency only at the official Chinese exchange rate.

Chinese reform proponents have stressed the need to establish links between the world financial market and China's banking system. We believe Beijing hopes that, by allowing foreign banks to establish branches only in the Special Economic Zones, it can gain experience and draw in foreign investment funds while limiting the influence of foreign banks on the Chinese economy. Beijing also may hope that competition from foreign banks will force Chinese banks in the Special Economic Zones to improve their services. We believe that allowing foreign banks to open branches in the Special Economic Zones may be, in part, a tacit admission that China's banking system is not capable of handling the burgeoning trade between China and Western countries. 25X1

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By the end of 1985, one joint-venture bank had been established in Xiamen, and four foreign banks had been granted permission to open branches in Shenzhen (the first allowed to open in China since 1949). Although press reports indicate other banks are interested in opening branches, we believe many foreign bankers remain wary of restrictions on bank activities and potential problems in remitting foreign currency earnings. 25X1

Risks of Reform 25X1

We believe Beijing faces two significant challenges to carrying out its bank reform program, both of which are illustrated by the 1984 credit surge and its aftermath. The first stems from a potential conflict between granting specialized banks increased autonomy, and strengthening the regulatory powers of the People's Bank. A primary goal of local banks is to maximize bank revenues by increasing the amount of outstanding loans, while a main concern of the central bank is to maintain macroeconomic stability by—among other things—preventing credit from expanding too rapidly. Therefore, Beijing must carefully match increases in bank autonomy with improvements in central bank control techniques. 25X1 25X1

The increased responsiveness of industrial production to monetary levers poses a second potential problem for Beijing. The state plan is no longer the sole determinant of the amount of investment spending by enterprises.[9] Bank loans constitute a growing portion of investment funds, and with the devolution of decisionmaking authority to enterprises, output has

[8] Since 1980 over 70 foreign banks have set up 140 representative offices in Beijing and other major Chinese cities, according to Chinese press reports. The representative offices, however, are restricted largely to providing liaison and consultation services and promoting trade.

[9] In 1978, over 85 percent of total capital construction investment was funded through the state budget, but by 1984, this had dropped to 40 percent. 25X1

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become more responsive to the total amount of bank credit in the economy. Beijing plans to conduct a more active monetary policy to maintain macroeconomic equilibrium, but poorly formulated or inappropriately executed monetary policy now will have a much more deleterious impact on the economy. Increasing or decreasing credit levels at the wrong time will cause sharper fluctuations in output than before the reforms. Beijing, therefore, must be especially cautious in formulating and monitoring credit policy. [redacted]

The 1984 Credit Binge

The dangers inherent in bank reform were highlighted by the performance of China's banking system during the past 18 months. Inappropriate monetary policy and lax oversight caused both currency in circulation and loans to industrial enterprises to grow by about 50 percent in 1984, with almost two-thirds of the increase coming in the fourth quarter. The credit surge continued in early 1985—with the PBOC reporting, for instance, that in the first quarter of 1985 the Agricultural Bank issued 3.2 times the amount of loans to rural enterprises as it did in the first quarter of 1984. According to China's State Statistical Bureau, enterprises used the growth in credit to launch new capital construction projects and hike wage funds—both of which grew at almost 40-percent annual rates during the first half of 1985. Strong consumer and investment demands caused industrial output to increase at a 23-percent annual rate during the same period. The excessive credit expansion caused China's official inflation rate to triple during 1985, and contributed to a 35-percent drop in its foreign exchange reserves between September 1984 and June 1985. [redacted]

Causes of the Credit Binge

Premier Zhao, in his March 1985 report to the National People's Congress, attributed the unexpected increase in credit to an accidental leak late in the year of a government decision to base 1985 credit limits on 1984 loan totals. In our view, while this may have exacerbated the problem, the credit and currency surges were caused by much more fundamental errors in Beijing's bank reform policy. We believe that policy was bungled when Beijing ordered the specialized banks to use their newly enhanced autonomy to increase support to economic development before the PBOC had developed adequate oversight and control mechanisms. [redacted] 25X1

The money supply surge actually began at midyear in 1984, rather than in the fourth quarter as Beijing claims. Figure 3 shows that the increase in currency in circulation in the third quarter of 1984 was twice the increase that occurred in the third quarter of any recent year. Growth of currency and credit accelerated after the Third Plenum of the 12th Party Congress in October 1984 placed the party's stamp of approval on measures designed to extend decision-making authority to lower levels throughout the economy. Demand for credit grew as enterprise managers used their increased autonomy to undertake investment projects and increase wage and bonus payments to workers. At the same time, government directives appearing in the Chinese press—as late as January 1985—called for specialized banks to support reform by expanding their loan business. We believe some bank managers thought that their bonuses would be based on the total amount of loans issued. [redacted] 25X1

We believe problems monitoring and controlling the credit surge arose because the PBOC had been slow to disentangle its accounts from those of the specialized banks. [redacted] 25X1
[redacted] separate clearing accounts for each specialized bank were not established with the PBOC until April 1985. We believe specialized banks responded to relaxed credit controls by boosting loans, and covered the extra lending by running up overdrafts with the PBOC. Press statements by central bank officials that the PBOC is not a cornucopia of funds suggest to us that the PBOC, whether witting or not, accommodated the specialized banks' increased demand for funds. [redacted] 25X1

Monetary Policy Response to the Credit Binge

In April 1985 Beijing clamped down on credit, using a combination of administrative controls and indirect monetary levers. At the time, Beijing announced its intention to restore monetary equilibrium gradually,

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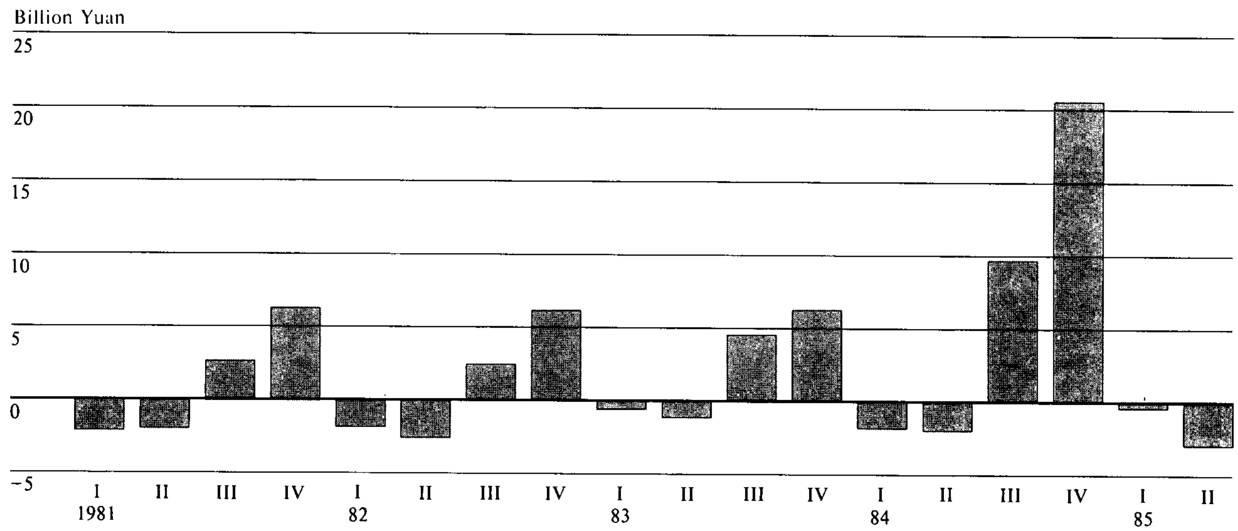
Figure 3
Change in Currency in Circulation by Quarter[a]



[a] The highly pronounced seasonality of China's currency in circulation is caused by the pattern of agricultural procurement and wage payments, and by the absence of countervailing monetary policy. According to reports in China's press, 60 to 70 percent of Chinese currency circulates in rural areas. State purchases of agricultural products after the harvest inject currency into the economy, and end-of-year bonuses for staff and industrial workers add to the late-year money supply increase.

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while strengthening oversight and control, without backtracking on fundamental bank reforms:

- The People's Bank was ordered to set and enforce quarterly credit limits for its branches and the specialized banks.
- Separate clearing accounts with the PBOC were established for each specialized bank.
- Interest rates were raised on time deposits held by individuals and enterprises, and on working capital and capital construction loans. (Interest rates were raised again in August 1985).
- To prevent indiscriminate increases in wages and bonuses, enterprises were required to place wage funds in special bank accounts to be monitored by the banks. Apparently, the payroll accounts of some units were frozen.
- Banks were ordered to stop offering loans to inefficient enterprises and to firms that produce poor-quality products for which there is little demand.

- Banks were prohibited from extending credit for capital construction projects whose spending exceeds the state quota or for projects not listed in the state plan.

- Enterprises and individuals requesting credit were required to pledge collateral equaling as much as 50 percent of the value of the loan.

- Banks were ordered to make a better effort at collecting overdue loans, and were urged to make use of a regulation, promulgated in March 1985, that allows banks to acquire the pledged collateral of borrowers who cannot repay their loans.

Aftermath of the Credit Binge
Although having only a mild impact on the pace of industrial production in the six months after it was implemented, Beijing's restrictive monetary policy caused severe credit shortages in some rural areas. Chinese newspapers reported that credit shortages contributed to sharp drops in purchases of fertilizer and farm implements, and in some provinces farmers were forced to accept IOUs when state procurement units ran out of funds to purchase the summer harvest.

Banks and enterprises in other regions have circumvented or ignored the tight money policies. Chinese press reports suggest that rural industries have proved particularly adept at raising funds outside the banking system to support rapid expansion of investment and output. Recent statements by the president of the PBOC that the volume of credit is still excessive, and a continuing widespread investigation of credit practices within the banking system, suggest to us that Beijing has not yet recovered from the credit binge.

Bank Reform Balance Sheet:
Benefits and Unresolved Problems

We believe China already has received substantial benefits from bank reform. Agricultural Bank credit probably played an important role supporting the development of livestock and cash crops by specialized households during the transformation of the agricultural sector from commune-based production to household farming. Rapid growth of rural industrial production, to a large extent, has been a result of loan support from rural banks. We believe that greater BOC flexibility in handling foreign exchange has facilitated increased trade and promoted development of joint ventures in China. Chinese press reports suggest that the increased use of loans in place of budget grants has sped up turnover of working capital and reduced construction periods. The introduction of new financial institutions and instruments probably has helped tap some of the substantial cash hoards reportedly held by peasants. We believe, however, that Beijing will be unable to realize the potential

Chen Muhua: President of the PBOC

The State Council appointed Chen Muhua president of the People's Bank of China in March 1985, probably to restore order to the banking system. Chen, formerly the head of the Ministry of Foreign Economic Relations and Trade (MOFERT), is an alternate member of the Politburo and has a reputation as a tough administrator. When Chen was head of MOFERT, she recentralized the trade apparatus, regained control over imports, and helped put an end to the trade deficits and foreign exchange problems that plagued China in the late 1970s and early 1980s.

Unlike her predecessor, Chen holds the rank of State Councilor, which gives her equal status with the heads of the State Planning Commission, the State Economic Commission, and the Ministry of Finance. Her position as a Politburo alternate, however, gives her higher party status than the heads of the three superministries. We believe her appointment to the People's Bank is not only consistent with Beijing's plans to increase the authority of the PBOC but may presage an unprecedented PBOC role in policymaking.

benefits from bank reform until it has resolved five major deficiencies.

Tenuous Monetary Control Techniques
By reducing the scope of central planning and delegating decisionmaking authority to lower levels, Beijing has increased the responsiveness of economic activity to monetary policy. In our view, monetary control techniques are not yet reliable, and Beijing faces substantial risks that monetary policy actually may be destabilizing—as it was in 1984. The potential danger is compounded by the fact that Beijing does not appear to know how sensitive the economy is to monetary tools—and the responsiveness of enterprises and consumers probably is changing as the economic reforms proceed.[10] In meetings with Western economists, Chinese officials have indicated that they are unsure what the appropriate rate of monetary growth should be. Beijing's policy of developing a profit-oriented banking system by granting specialized banks greater flexibility in issuing loans may be at odds with its desire for better PBOC control over credit.

Improper Banking Practices
The specialized banks do not always use their increased autonomy in ways that Beijing intended. Chinese media report that bank competition for borrowers has resulted in the issuance of inadequately secured loans and the slashing of interest rates (in excess of regulations) to unprofitably low levels. Chinese media also report that local political pressures, not economic criteria, continue to determine the direction of loans. Some local party officials have threatened bankers with the loss of party membership if they do not accede to their demands for loans. Other press reports tell of local officials browbeating bankers for loans, and then using the funds to set up illegal companies. Banks apparently have no effective way of stopping enterprises from using loans for purposes other than those laid down in the loan contract, or compelling enterprises to repay them. 25X1

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Shortage of Skilled Managers and Inadequate Infrastructure
China faces a critical shortage of skilled bank managers. Under the Maoist banking system, managers for the most part did not have to make decisions based on economic criteria, or conduct loan and project evaluations, and therefore did not develop the skills required by modern banking practices. Beijing also lacks the physical infrastructure—such as modern telecommunications and an integrated computer network—necessary for sophisticated banking operations (although Beijing increasingly is introducing computers in the banking system). 25X1

Irrational Price Structure
We believe that banking reform may not bring about a significant improvement in the allocation of funds if China's present irrational price system is not also reformed. In the absence of price reforms, the use of 25X1 indirect monetary tools to control aggregate demand might cause a greater misallocation of resources than administratively set credit limits. For instance, if the PBOC decides to raise interest rates to slow investment spending, enterprises that sell goods at high state-set prices may continue to afford loans, even if the enterprises are poorly managed. On the other hand, higher interest rates may force efficient firms to reduce borrowing and scale back production if their output must be sold at irrationally low prices. Initial efforts to reform urban food prices in 1985 caused the cost of living to soar and met with stiff consumer resistance, and Chinese officials are now saying that price stability—rather than price reform—will be emphasized in 1986. 25X1

Absence of Enterprise Bankruptcy Laws
In our view, the lack of bankruptcy laws for Chinese enterprises has contributed to Beijing's difficulty controlling excessive credit. Managers have taken advantage of their new decisionmaking authority by borrowing funds to increase investment or employee's

[10] The large magnitude of China's currency flows relative to the total amount of currency in circulation makes it more difficult to maintain monetary equilibrium. In 1984, retail sales were over four times higher than currency in circulation, and the value of the increase in gross agricultural production corresponded to 50 percent of the average stock of currency during the year. A small variation, therefore, in wages, prices of agricultural products, or farm output could have a large impact on the stock of currency.

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wages, but, because Beijing still pays the operating expenses of state enterprises that lose money, firms can expand their borrowing without worrying about bankruptcy. Local banks, similarly, expand credit freely because they believe higher authorities will bail them out if they make bad loans. Beijing recognizes the need to allow enterprises to go bankrupt, but the irrational price system makes it difficult to determine which enterprises should be closed. Beijing, moreover, is reluctant to proceed with price reform while inflationary pressures—caused by excessive credit—are still strong. We believe Beijing will resolve its dilemma by proceeding with reforms on two fronts. First, Beijing will improve its ability to conduct active monetary policy by increasing and sharpening the monetary instruments at the PBOC's command, and, temporarily, allow the PBOC greater use of administrative controls over credit. Second, Beijing will gradually implement the other components of its reform program, thereby making economic entities more responsive to market forces—including monetary levers.

Progress rectifying the five deficiencies will not only boost the economic returns from bank reform, but also will pay political dividends to Chinese reformers. Since the reforms began party conservatives have argued that mandatory planning should play the primary role in maintaining macroeconomic stability, and that strict limits, therefore, must be placed on economic decentralization. We believe that reforms have proceeded, in part, because leaders are convinced that they can control economic activity successfully by employing indirect economic levers—such as interest rates and credit levels. Conservatives are quick to attack shortcomings, however, and have criticized Deng Xiaoping and members of his reform coalition for mismanaging the economy during the past year. Successfully transforming the People's Bank into a central bank capable of using indirect monetary tools to regulate credit in a decentralized banking system would, in our view, strengthen the hand of the reformers and improve the chances for the overall reform program.

To meet China's ambitious development goals, banks and enterprises must make better use of existing financial resources. Enhancing the flexibility of banks to meet local credit needs and increasingly using interest rates to ration funds should, we believe, improve the allocation of resources while satisfying enterprises' demands for funds without resorting to inflationary issuance of currency. 25X1

Trends

Progress to date suggests to us that the following trends probably will emerge in China's banking reform:

- *Increased Use of Interest Rates as Economic Levers.* Beijing will adjust the structure of interest rates more frequently to compensate for changes in economic conditions—rates probably will be raised again within the next year. Banks also will be given greater flexibility in setting interest rates on loans.

- *Increased Competition Among Banks.* Beijing gradually will allow increased competition among banks, both by allowing domestic banks to undertake banking operations formerly reserved to a particular specialized bank, and by granting foreign banks a wider range of activities. Experiments with bank competition will be limited at first to the Special Economic Zones and then may spread to other areas in China. 25X1

- *Increased Range of Financial Instruments.* Beijing will continue to experiment with new financial instruments such as bank bonds (certificates of deposit), enterprise shares, and mutual funds.

- *Establishing a Short-Term Capital Market.* According to a party journal, the president of the People's Bank recently said that "conditions for opening a short-term capital market are ripening." Beijing's initial steps include: allowing banks to borrow from each other, permitting the discounting or mortgaging of government bonds, authorizing interenterprise credit, and allowing banks to raise funds by issuing bonds. The president of the PBOC made it clear, however, that in the near future 25X1

Beijing will not allow stocks and bonds to be issued on a large scale. [redacted]

Beijing probably will introduce new banking reforms at a slow, measured pace, particularly during 1986-87. Some financial reforms, however, such as the development of private credit institutions, may prove difficult to control. In the short run Beijing will closely monitor credit. Although we do not expect a repetition of the 1984 credit surge this year, we do expect Beijing to experience cycles of overexpansion and contraction of credit as it refines central bank monetary tools and gives local banks more flexibility over lending. [redacted]

Even if the PBOC successfully develops sophisticated monetary tools, we believe Beijing's reforms will fundamentally alter macroeconomic conditions in China, and the economy may begin to experience the periodic bouts of inflation that occur in market economies. Poorly formulated monetary policy will accentuate inflation or recession. [redacted]

When bank reforms are implemented fully, the state will continue to dominate the banking sector, and foreign or nongovernmental banks will have only a limited scope of operations. As such, the banking system will retain many of the characteristics of a monopoly bank and will provide Beijing with a powerful economic control mechanism. In our view, a stronger and more active central bank is compatible with an economic system that combines mandatory planning and market forces. Monetary policy will remain subordinate to the needs of the economic plan—and banks will continue to be required to offer preferential interest rates to priority sectors and to support designated loss making enterprises—but the banking system will be able to respond much more efficiently and flexibly to credit needs and economic conditions. [redacted]

Implications for the United States

We believe bank reform will facilitate increased trade with China. As the People's Bank increasingly functions as a true central bank, the BOC will operate more as a commercial bank—and less like a foreign exchange bank for the state—and may be more willing to lend foreign exchange for imports and joint 25X1
ventures. Greater competition between the BOC and the CITIC for customers may foster trade, as will enhanced flexibility in conducting banking operations. [redacted] 25X1

As a result of bank reform, China probably will play a larger role in the international financial system. For the first time since 1949, China has issued foreign-currency-denominated bonds for public subscription outside China, and in the next few years, the BOC or the CITIC may consider issuing bonds in the United States. Proceeds from sales of foreign currency bonds 25X1
may go toward Chinese imports of industrial equipment and high-technology products. [redacted] 25X1

Successful bank reform would increase opportunities for US banks to set up offices in China. The US Consulate in Hong Kong reported last summer that one US bank already was negotiating to form a joint-venture bank in the Xiamen Special Economic Zone. 25X1
Foreign branch banking is in its infancy, but, as the PBOC gains experience regulating foreign branches, we expect Beijing to allow more foreign banks in China, and permit them to broaden the scope of their operations. In the short run, Beijing will continue to restrict foreign branches to the Special Economic Zones, and to foreign trade and investment financing. Reform, however, should provide opportunities for US banks to offer managerial services to Chinese financial institutions. [redacted] 25X1

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